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CZECH REPUBLIC

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Prague, 18 September 2015

Mr Francesco Mazzaferro
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European Systemic Risk Board

NOTIFICATION

**of the setting the countercyclical capital buffer rate for the Czech Republic No. III/2015
applicable from 1 October 2016**

The Czech National Bank decided at the meeting of its board of 3 September 2015 that the countercyclical capital buffer rate for the Czech Republic shall be set at 0% of the total risk exposure. Banks, credit unions and investment firms shall apply this rate for the purposes of calculating the combined buffer requirement as from 1 October 2016. The decision was published by means of provision of a general nature on 18 September 2015.

Justification for the decision:

1. Pursuant to Article 12f(3) of the Act on Banks, Article 8ac(3) of the Act on Credit Unions and Article 9ac(3) of the Capital Market Undertakings Act, the Czech National Bank shall set the countercyclical capital buffer rate for the Czech Republic, taking into account the countercyclical capital buffer guide calculated pursuant to Article 12f(1) and (2) of the Act on Banks, Article 8ac(1) and (2) of the Act on Credit Unions and Article 9ac(1) and (2) of the Capital Market Undertakings Act, the recommendations issued by the European Systemic Risk Board (ESRB) and any indicators that can identify growth in systemic risk. Pursuant to Article 12f(1) of the Act on Banks, Article 8ac(1) of the Act on Credit Unions and Article 9ac(1) of the Capital Market Undertakings Act, the buffer guide is based on the deviation of the credit-to-GDP ratio from its long-term trend – the credit-to-GDP gap. Pursuant to Article 12f(2) of the Act on Banks, Article 8ac(1) and (2) of the Act on Credit Unions and Article 9ac(1) and (2) of the Capital Market Undertakings Act, when calculating the buffer guide the Czech National Bank shall take into account in particular the credit cycle and growth in loans provided in the Czech Republic, changes in the credit-to-GDP ratio, the specificities of the Czech national economy and the recommendations issued by the ESRB.

2. In accordance with the ESRB Recommendation¹, total credit means the value of all loans provided to the private sector (non-financial corporations, households and non-profit institutions serving households) plus the volume of bonds issued by the domestic private sector. The time series of 1995–2015 and – in line with the ESRB Recommendation – the Hodrick-Prescott filter with a smoothing parameter (λ) of 400,000 were used to calculate the long-term trend. The standardised credit-to-GDP ratio was 76.6% and its deviation from the long-term trend 4.4 percentage points in 2015 Q1. These values imply setting the benchmark countercyclical capital buffer rate pursuant to Article 12f(1) and (2) of the Act on Banks, Article 8ac(1) and (2) of the Act on Credit Unions and Article 9ac(1) and (2) of the Capital Market Undertakings Act at 1.00%. In reaction to the ESRB recommendation, however, the Czech National Bank has repeatedly emphasised in its publications (particularly the Financial Stability Report) that the said calculation method is not appropriate for the Czech economy in view of its specificities and so cannot be taken into account in full when deciding on the rate. The specific features of the Czech economy include the limited length of the time series of the credit-to-GDP ratio, structural (non-cyclical) breaks caused by the banking crisis in the late 1990s and trends typical of converging economies. For this reason, when setting the countercyclical capital buffer rate the Czech National Bank prefers to apply an approach based on a wider set of indicators and taking account of the specific features of converging economies rather than applying the above-mentioned mechanical rule.

3. The estimate of the long-term trend of the credit-to-GDP ratio used to calculate the buffer guide is affected mainly by the fall in loans recorded in the late 1990s and at the start of the 2000s. This was caused by write-offs of non-performing loans from banks' balance sheets. The Czech National Bank therefore deems it necessary to calculate the additional deviation of the credit-to-GDP ratio from its long-term trend based on a shorter time series which does not include periods with write-offs of non-performing loans (i.e. on the time series starting in 2004). The deviation of the trend calculated in this way was -4.7 percentage points in 2015 Q1 and implies a zero countercyclical capital buffer rate. At present, this indicator better characterises the position of the Czech economy in the financial cycle.² Despite this, its values should be regarded only as indicative, and a more comprehensive assessment of the situation based on other relevant indicators should be taken into account when setting the rate.

4. The overall credit market situation is characterised by increasing activity. In June 2015, the annual growth rate of bank loans to non-financial corporations was 4.8% and that to households was 6.7%. Despite the upward trend, both these figures are still below the ten-year average, and the estimate of future growth in bank lending to the private sector as evaluated in previous macro stress testing (June 2015) does not currently indicate any risk of excessive credit expansion. The lending activity of non-bank intermediaries confirms an upward trend in the case of non-financial corporations, where loans rose by 7.9%. Non-bank intermediaries' loans to households fell by 3.0% year on year in 2015 Q1.

5. None of the other indicators are at elevated risk levels. The speed of private sector borrowing relative to income is low by comparison with the pre-crisis period, and total debt service does not represent an excessive burden from the aggregate perspective. The recovery on the residential property market was modest during 2014 and in the first half of 2015 and residential property prices are close to their equilibrium values according to the Czech National Bank's analyses. Despite a slight increase in optimism at the beginning of 2015, the capital market is generally flat due to conditions in Europe. The bank lending conditions are the only indicator signalling a shift of the Czech economy towards an excessive growth phase of the financial cycle. Although the lending conditions for the private sector were further loosened, there are no major changes so far in other segments of cyclical risks. As a

¹ Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1).

² See the comparison of the indicators of excessive borrowing and accumulation of risks in Table IV.3 in Financial Stability Report 2014/2015.

consequence, the countercyclical capital buffer is not the most appropriate macroprudential tool for mitigating the arising fractional risk.³ An aggregate indicator of the financial cycle combining the above indicators and taking into account their mutual correlation confirms that the Czech economy rebounded definitively from the bottom of the financial cycle⁴ and the credit dynamics are continuing to rise. However, the growth phase of the financial cycle (in which the economy is currently to be found) can be still regarded as non-excessive. Taking into account the additional deviation of the credit-to-GDP ratio from its long-term trend and other relevant indicators, the value corresponding to the guide for setting the countercyclical capital buffer rate according to the ESRB Recommendation⁵ is 0%.

6. Overall, the indicators that can identify growth in credit risk can be assessed as suggesting that the Czech economy has shifted into a phase of non-excessive growth in the financial cycle. The credit market situation still does not indicate signs of over-optimistic expectations and the taking on of excessive credit risk. The current level of the time dimension (cyclical source) of systemic risk is still rather low and does not require the creation of a countercyclical capital buffer for exposures located in the Czech Republic. The Czech National Bank has therefore decided to set the countercyclical capital buffer rate for exposures located in the Czech Republic at 0%. However, given the accelerated credit dynamics, loosening of credit standards and growth in investment sentiment, the probability of a zero countercyclical capital buffer rate being set in the next two years has further decreased.

7. The institutions shall apply this rate as from 1 October 2016.

Should there be a need for further explanation, please feel free to contact myself: Jan Frait, Executive Director, Financial Stability Department (Jan.Frait@cnb.cz, +420-224414430).

Yours sincerely

³ See section 4.4 of Financial Stability Report 2014/2015.

⁴ The indicator is described in detail in the article *An indicator of the financial cycle in the Czech economy* published in Financial Stability Report 2013/2014 (pp. 118–127).

⁵ Recommendation B(4).